

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF OWEN COUNTY RURAL)	
ELECTRIC COOPERATIVE CORPORATION FOR)	
THE AUTHORIZATION TO CONVERT CERTAIN)	CASE NO. 89-156
NRUCFC NOTES TO A FIXED RATE)	

O R D E R

On June 7, 1989, Owen County Rural Electric Cooperative Corporation ("Owen County") filed a request that the Commission grant approval of the conversion of National Rural Utilities Cooperative Finance Corporation ("CFC") Loan No. 03-20-037-9011 ("9011"), Loan No. 03-20-037-9014 ("9014"), Loan No. 03-20-037-9016 ("9016"), Loan No. 03-20-037-9021 ("9021"), and Loan No. 03-20-037-9024 ("9024"), from a variable to a fixed interest rate. The terms of these 35-year loans originally provided for a fixed interest rate for the first 7 years, after which, the rate would be renegotiated. By the Commission's Order in Case No. 10045,¹ Owen County was authorized to convert these loans from the fixed to the variable rate program. CFC loan policies provide that, once the variable rate option has been selected, a borrower may convert back to the fixed rate program at any time without a conversion fee and the rate will be fixed for a 7-year period. On January 26, 1989, Owen County's board of directors voted to convert these loans back

¹ Case No. 10045, The Application of Owen County Rural Electric Cooperative Corporation to Convert Fixed Loans to Variable Interest Rate, final Order issued November 12, 1987.

to the fixed rate, effective March 1, 1989. CFC has been charging the fixed rate on these loans pending approval by the Commission.

In the Commission's final Order in Case No. 10045, Owen County was ordered to "analyze all future refinancing options in a manner that clearly reflects the costs and/or savings associated with such options."² However, in its application in this proceeding, Owen County filed no analysis to support the request to convert the CFC loans back to the fixed interest rate. In response to the Commission's Order of July 10, 1989, Owen County filed seven scenarios utilizing an Internal Rate of Return ("IRR") approach in evaluating its financing options. Under the IRR approach, the goal of the borrower would be to utilize the interest rate program which produces the lowest IRR. However, in four of the seven scenarios, the IRR analysis indicated that the loans should remain in the variable interest rate program. Owen County did not explain which, if any, of these scenarios represented its expectations of future interest rate fluctuation. In response to the Commission's Order of August 4, 1989, Owen County submitted another IRR scenario which did indicate a significant savings in converting the loans to the fixed rate. However, Owen County did not explain how it arrived at its variable interest rate assumptions used in the IRR analysis.

In its application, Owen County stated its belief that converting to the fixed interest rate at this time would "... stabilize the cost of borrowed funds and avoid the risk of further

² Id., page 6, ordering paragraph 6.

increases. . . ."3 In the response to the Commission's Order of August 4, 1989, Owen County stated its decision to convert to the fixed interest rate was based on such factors as:

. . . no increase to convert from the variable rate to fixed rate since the variable rate in March 1989 was 10.5 percent and the standard fixed rate was 9.5 percent plus 50 basis points; the opinion that variable rates would not drop to such a level that there would be a significant risk in being committed to a fixed rate; the belief that our long-term debt should not be financed by variable rate loans; the fact that we had achieved our goal of lowering the original rates on these loans to a more desirable level. . . .4

Owen County submitted no further explanation in support of its decision to convert to the fixed interest rate.

The Commission has reviewed the interest rates CFC has charged under the loan options from 1985 to the present. For the period 1985 to 1988, the variable interest rate has always been lower than the converted fixed rate. On January 1, 1989, CFC eliminated its converted fixed rate program and allowed conversion from variable rate loans to fixed rate loans bearing interest equal to the standard fixed rate plus 50 basis points (1/2 of 1 percent). For the 8 months of 1989, the variable and fixed rates were equal in January, February, and July; from March to June, the variable was higher than the fixed rate, but never by more than 50 basis points; and in August, the variable rate was slightly lower than the fixed rate.

3 Application filed June 7, 1989, page 3.

4 Response to the Commission's Order of August 4, 1989, Question 5.

The IRR analysis performed by Owen County does not adequately support the decisions to convert to the fixed rate. To be effective, the use of an IRR analysis requires the user to make specific assumptions concerning changes in interest rates. While it is difficult to predict the interest rates of the future, reasonable assumptions can be made using historic trends, the current condition of the financial markets, and an evaluation of related economic factors. The scenarios provided by Owen County reflect a set of assumptions about interest rates; however, Owen County has not indicated what its expectations are concerning future interest rates. Without an indication of Owen County's expectations for interest rates, the IRR analysis simply shows options to consider and does not provide support for a decision to convert the loans. As was previously noted, Owen County was ordered in its last financing case to provide an analysis which clearly reflected the costs and/or savings of any proposed refinancing. Owen County has not complied with this requirement.

The changes in the available CFC interest rates during 1989 do not clearly indicate a benefit from converting to fixed rates at this time. The variable interest rates have been declining steadily since May and, as of August, were below the available fixed rate and exceeded Owen County's fixed rate by only .125 percent. Given the current economic conditions, it is reasonable to expect interest rates in the short term to continue to decline. Considering CFC's historic trends, both the variable and the available fixed rates would be expected to decline. It would appear likely that the available fixed rate could even reach a

level lower than the 10 percent Owen County has tentatively converted to.

Two of the factors cited by Owen County as a basis for its decision to convert to the fixed rate are of concern to the Commission. First, Owen County stated that it did not believe the variable interest rates would drop to such a level that there would be a significant risk in being committed to a fixed interest rate. If this statement is true, then Owen County must have formulated some expectations of what would be happening to interest rates. However, when Owen County was asked to explain its expectations concerning interest rates, Owen County could not provide any indications of what it expected.⁵ Owen County also stated its decision to convert was based on the belief that long-term debt should not be financed by variable rate loans. The Commission understands Owen County's position with regard to the amortization of the principle of its debt capital; however, if variable interest rate loans with 35-year amortization periods result in lower financing costs to the cooperative and its members, it would be a prudent decision on the part of the cooperative to utilize variable rate loans. The interest rate option selected by the cooperative does not affect the term of the debt obligation under CFC financing.

The Commission is very concerned with Owen County's practice of refinancing its long-term debt and then seeking the Commission's approval several months after the effective date of the

⁵ Id., response to Question 3.

change. In Case No. 10045, Owen County refinanced these same five loans effective December 1, 1986 and did not seek Commission approval until October 5, 1987, 10 months later. In this case, the refinancing was effective March 1, 1989 and Owen County sought Commission approval on June 7, 1989, 3 months later. Owen County is obligated by statute, KRS 278.300, to obtain Commission authority prior to refinancing its debts. The Commission advises Owen County that in future refinancing proceedings, Owen County will be expected to notify the Commission in a prompt, timely manner.

The Commission is of the opinion, based on the conditions presented in this case, that Owen County's decision to convert the five loans to the fixed interest rate program is not justified and the request should be denied without prejudice. However, Owen County may file additional information and explanations to further support its request. If Owen County seeks to pursue this refinancing, it should file for each loan three scenarios using the IRR model. One scenario should reflect Owen County's "best case" expectations, i.e., steady or lowering interest rates, for future interest rates over the next 7 years; one scenario should reflect Owen County's "worst case" expectations, i.e., steady or rising interest rates, for future interest rates over the next 7 years, and one scenario reflecting Owen County's most realistic expectations for future interest rates. The assumptions in these scenarios should reflect the cyclical nature of interest rates. Furthermore, the assumptions used to develop each scenario should be fully explained, even if those assumptions are based only on

Owen County's personal opinions. Owen County should also file a schedule showing how much it has saved in interest expense in converting to the fixed rate. This schedule should be prepared on a monthly basis, showing the outstanding loan balance for each month and the monthly interest expense under the variable rate and the March 1, 1989 fixed rate, and should cover the period from March 1, 1989 to the date of filing this information. Finally, Owen County should provide a thorough explanation of what it anticipates fixed loan interest rates will do in the near future.

FINDINGS AND ORDERS

Based on the evidence of record and being advised, the Commission is of the opinion and finds that:

1. On January 26, 1989, the board of directors of Owen County voted to convert CFC Loan Nos. 9011, 9014, 9016, 9021, and 9024 from the variable to fixed interest rate program.

2. The information and explanations filed by Owen County in support of the conversion do not adequately demonstrate that the conversion is in the best interests of Owen County and its consumer-members at this time.

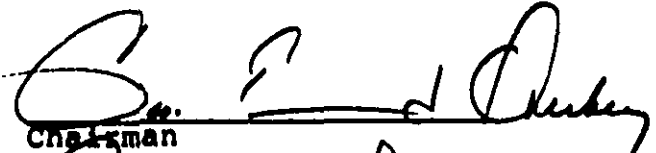
3. The conversion of the subject loans should be denied without prejudice.

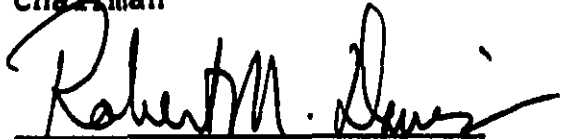
4. Owen County may file a petition for reconsideration supported by additional analysis and explanations to justify the requested conversion.

IT IS THEREFORE ORDERED that Owen County's conversion of CFC Loan Nos. 9011, 9014, 9016, 9021, and 9024 from the variable to fixed rate program be and hereby is denied.

Done at Frankfort, Kentucky, this 26th day of September, 1989.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Executive Director